



Legislative Audit Division

Performance Audit Summary

Improving Taxpayer Compliance in Montana Through Audit Efforts June 2006

Introduction

The Department of Revenue (DOR) administers Montana's tax laws and serves as the general tax collection agency. Revenue collection responsibilities necessitate appraising values of taxable property, assessing tax liability, and auditing for taxpayer compliance. Three of the main revenue components of the state's General Fund are individual income, corporate license, and natural resource taxes. In fiscal year 2005, the state's General Fund collected more than \$1.46 billion of which 60 percent was from these component taxes. The department's compliance audit efforts resulted in collections of \$45.8 million including penalties and interest.

The Legislative Audit Committee requested a performance audit of DOR's compliance audit function. We examined audit activities from 2002 through the present. The audit objectives focused on answering the following questions:

- If the audit function is focused to meet the department's stated goals and mission?
- If there are established performance measures and if those measures are reasonable?
- If information resources and analysis are used to reevaluate policies and organizational goals?
- If audit staff resources are aligned to maximize effectiveness of audit efforts?

Background

Audit is one of the tools used by the department to support its compliance function. All audit activities are consolidated in the Business and Income Taxes Division (BITD). This division is responsible for ensuring compliance with tax laws. DOR's audit staff are located in Helena and in several of the state's larger cities. Staff perform both office audits and field audits. Field audits involve travel to corporate or business headquarters.

Estimating Taxpayer Compliance

Under a voluntary system of taxation, citizens compute, report, and remit taxes due at the time and in the manner set by state and federal tax laws. Each year a difference arises between what taxpayers should pay and what they actually pay. This difference is referred to as the "tax gap" and is a recognized measure of taxpayer compliance. The

tax gap occurs at both the federal and state levels. Periodically, federal and state taxing agencies estimate the size of their tax gap.

Taxpayer Noncompliance in Montana

Using federal analysis as a starting point, Montana's 2005 estimated underpaid state taxes are \$145-195 million for individual income and \$33-45 million for corporate license taxes. The overall noncompliance rate is estimated at 18-22 percent for individual income and 26-33 percent for corporate license tax, which reflects percent of dollars misreported. DOR's estimates are net amounts and represent underreported taxes remaining after the department's audit function recovers some of the taxes due. DOR estimates include the following key findings:

- Taxpayer noncompliance with individual income and corporate license tax laws results in significant underpayment of taxes in Montana.
- Taxpayer noncompliance is increasing in Montana with the individual income tax gap increasing between 1992 and 2005.
- Montana's individual income tax gap (18-22%) is higher than other states who have recently completed tax gap analysis. Specifically, Minnesota and California estimate their individual income tax noncompliance rate at 11 percent.
- For corporate license tax, the estimated percentage of tax gap is higher for Montana (26-33%) than for the nation as a whole (12%).

Montana's taxpayer noncompliance is relatively significant. DOR recognizes the need to develop a plan to reduce the tax gap and improve taxpayer compliance.

Long-Term Planning Needs to be Done

DOR needs to complete a strategic planning effort to help focus its audit activities. Current audit activities are not focused on achieving quantifiable results tied to the department's goals or objectives. The lack of long-term planning has resulted in the department initiating a number of audit activities without a coherent strategy. Long-term planning can focus audit activities on reducing taxpayer noncompliance and will allow the department to prioritize its efforts, identify performance expectations, measure results, and determine when goals and objectives have been

achieved. Long-term planning will help the department realign its resources in the face of emerging requirements without losing focus on its overall mission. ***The department needs to first complete a strategic planning effort to focus its audit activities on reducing taxpayer noncompliance and establish priorities to achieve audit goals and objectives.***

Using Performance Measures

A primary component of any long-term planning process is the establishment of performance measures to gauge achievement of goals and objectives. We found the department's audit activities generally lack a means of determining their overall effectiveness. If the department were to develop performance measures to compare to initial expectations, it could make data-driven, results-oriented decisions about whether to continue or eliminate specific activities. ***We recommend the department identify performance goals and collect performance data for audit activities to determine their effectiveness.***

Tax Gap Analysis is a Tool for the Department

A tax gap will always exist but the data derived from analysis of the gap can be a tool for administration of the audit function. Results of tax gap studies can be incorporated into DOR decision-making. Regular tax gap studies can become key to the department's activities to improve taxpayer compliance and form a foundation for the department's efforts in establishing goals, objectives, and priorities. The department has not regularly conducted tax gap studies or used previous results as a means of measuring the effectiveness of its policies or activities. ***We recommend the department conduct regular tax gap studies to measure compliance with Montana's tax laws and provide the results to the legislature.***

Strengthening the Compliance Audit Function

Multiple studies have shown one key to improved taxpayer compliance is a strong enforcement program. Audits are one activity that has a statistically significant impact on taxpayer compliance and are among the compliance activities with the largest indirect effect relative to their cost.

While there are other components for improving taxpayer compliance such as simplicity of tax laws and forms, taxpayer education, improved disclosure of tax-related information and pre-paying taxes due through withholding – tax enforcement programs are a proven key component.

After completing strategic planning activities and establishing performance measures the department needs to shift existing resources to areas that have the potential to be more productive at eliminating the known tax gap, collecting additional underreported income, and maximizing the department's net rate of return.

Exploratory efforts into other potential areas of noncompliance should continue to be done at a lower priority until better data is developed to justify the use of limited resources. Similarly, audit efforts should be tempered by targeting those areas where the department has the highest potential for collecting revenues with its existing tools.

We recommend the Department of Revenue more effectively deploy audit resources by directing audit activities to focus on the following factors to achieve the greatest benefit:

- ***Areas of greatest taxpayer noncompliance as identified in the tax gap.***
- ***Opportunities to generate the highest net returns.***
- ***Areas with the strongest legal enforcement and collection tools.***
- ***Opportunities to provide staff training.***
- ***Opportunities to reduce inequities in filing rates among major tax filing groups.***

We also recommend the department conduct an analysis of the department's existing legal, enforcement, and collection tools to improve the department's ability to secure tax compliance from nonresidents.

As audit functions and emphasis evolves, skill sets and staffing levels may change. ***Department management will need to complete a staffing analysis to respond to the changes in staff responsibilities within the three tax units.***

This staffing analysis will serve as a framework to ensure staff have the knowledge, skills and abilities to perform the audit work associated with each tax unit as new responsibilities emerge; identify training opportunities to enhance employee skills; identify areas where staff specialization could improve specific skills; and, make staff assignments that are appropriate for skills needed - putting the right people in the right jobs. A staffing analysis will also identify and justify future staffing needs.

For a complete copy of the report (06P-10) or for further information contact the Legislative Audit Division at 406-444-3122; e-mail to lad@mt.gov; or check the web site at <http://leg.mt.gov/css/audit/>